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In the Supreme Court
Of The United States

OCTOBER TERM, 1985

RICHARD H. FOSTER AND SARA B. FOSTER, T. JACK FOSTER, JR., AND PATRICIA FOSTER, JOHN R. FOSTER AND CAROLINE FOSTER, AND ESTATE OF T. JACK FOSTER, DECEASED, GLADYS H. FOSTER, EXECUTRIX, AND GLADYS H. FOSTER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED

1.a. Whether the Commissioner of Internal Revenue is empowered by Internal Revenue Code Section 482 to deny the tax incidents of property transfers to viable controlled corporations which Congress provided in Sections 351 and 358, and in the provisions taxing corporate income and losses differently from those of individuals, merely because the taxpayers selected the corporate form of operation in order to obtain those favorable tax incidents.

b. As an alternate statement of this issue, does the Section 482 grant of discretionary power in the Commissioner to "allocate" income and deductions in order to "prevent evasion of taxes" mean the same as discretion to allocate to "prevent avoidance of taxes", with the consequence that he can allocate to deny

any taxpayer's deliberate invocation of a statutory tax minimization if the taxpayer knew it would "avoid" otherwise higher taxes.

2. If the answer to the first question is affirmative, whether the authority can be conferred on an administrative official to decide in his discretion, without statutory guidelines, when tax incentives and favorable tax incidents for which Congress has provided should be denied, without violating the separation of powers principle, or, if it be different, the prohibition against delegation of powers.

3.a. Whether notes representing the purchase price of stock of a corporation owning 200 acres of land in the area being developed for subdivision could be in substance interest, where the obligee had not loaned any money and the notes were, as to it, principal; where the

actual lenders were not the obligees of the notes, but did receive market-rate interest on the loans they made; and there was no stock relationship between the obligee of the notes and the actual lenders which would permit the lenders ever to profit from the notes.

b. Whether Internal Revenue Code Section 266 denies taxpayers the right to elect to capitalize the notes even if they were interest, because they were on the cash basis of accounting instead of the accrual basis.

4.a. Whether, in view of Rule 301 of the new Rules of Evidence, a trial court in an income tax case, can properly hold that the presumption that the Commissioner's position is correct survives the presentation by the taxpayer of a normally prima facie case where no evidence is presented by the Commissioner, merely because the issue

involves a deduction instead of gross income.

b. Whether, in the foregoing question,the extent of the prima facie case is enhanced by uncontradicted evidence that the particular expenditures which were disallowed for lack of the required substantiating documentation were not identified by the Commissioner in his deficiency letter, in his pleading in the Tax Court, or at trial, and the taxpayers' evidence established that the revenue agent had left their records so scrambled that the taxpayers could not tell from them what was disallowed, that the agent's work papers were unintelligible, and the taxpayers' evidence proved that they had established a system specifically designed to satisfy the statutory requirements and the operational system should not have permitted any improper deductions to slip through

it.

5. Whether in a case involving an allocation by the Commissioner under Section 482, the burden is on the taxpayer to prove that administrative action was arbitrary and unreasonable, or merely that it was unwarranted, particularly in the light of newly adopted Rule of Evidence 301 and its legislative history.

6. Whether the Court of Appeals erred in refusing to take judicial notice under Rule of Evidence 201 of a deposition subpoenaed by respondent from the possession of the California Superior Court, in spite of the mandatory duty to do so declared in Rule 201(d), and in treating the offer of the deposition under Rule 201 as a motion to augment the record and then denying it, where respondent had subpoenaed the deposition but withheld it from evidence on the

representation to the trial court that it was merely cumulative of a prior deposition on which the trial judge subsequently relied but which in fact it contradicted, thus producing the result that the trial court relied on statements in a deposition which were contradicted by the same person in the second, suppressed, deposition.

7. Whether Estero Municipal Improvement District, a public agency of the State of California created by special act of the Legislature with the power to borrow money by issuing tax exempt bonds, to levy and collect taxes, and to employ staff and independent contractors, and with the function of converting semi-submerged land into a city, can be held to be the mere alter ego of these taxpayers, so that the increased land values created by that conversion can be treated as allocable to

them under I.R.C. Section 482, and not to the actual corporate owners.

8. Whether, if the court below correctly held that the activities of Estero in improving the area through the work of its officers, employees and independent contractors financed by the sale to the public of tax exempt bonds, are the activities of the individuals here, and the activities of a private corporation owned by these individuals in employing them and others to perform the developers activities are also activities of these individuals and not corporate activities, these individuals clothed themselves in the corporate form of one public corporation and one private corporation, and thereby operated as an association taxable as a corporation?

9. Whether a trial judge may properly refuse to permit a witness to correct testimony given in a deposition

which had been admitted into evidence by using the precise phrase which he had used in the deposition testimony.

10. Whether under rule of Evidence 804(b)(1) and (5) a discovery deposition taken of the plaintiff by the defendants in a state court action involving parties and issues different from those in this case, without cross-examination and without any motive to test the credibility of the testimony in the deposition, is admissible in this tax case.

PARTIES TO THE PROCEEDING

The caption of the petition contains the names of all parties to the case.

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Richard H. Foster and Sara B. Foster, T. Jack Foster, Jr., and Patricia Foster, John R. Foster and Caroline Foster, and Estate of T. J. Jack Foster, Deceased, Gladys H. Foster, Executrix, and Gladys H. Foster petition for a Writ

of Certiorari to the United States Court of Appeals for the Ninth Circuit, to review its decision rendered in this case April 3, 1985, petition for rehearing denied May 30, 1985.

OPINIONS BELOW

The opinion of the Court of Appeals is reported in 756 F.2d 1430, and is reproduced in the Appendix. The opinion of the Tax Court is reported in 80 T.C. 34.

JURISDICTION

The jurisdiction of this Court is invoked under Section 1254 of Title 28, United States Code and Section 7482(a) of the Internal Revenue Code. Jurisdiction of the United States Court of Appeals for the Ninth Circuit lay under Section 7482 of the Internal Revenue Code. It filed its decision on April 3, 1985; petition for rehearing was filed on April 17, 1985, and denied on May 30, 1985. The opinion of the United States Tax Court

was filed January 11, 1983. Its judgment was entered on August 8, 1983, and the appeal to the Court of Appeals was filed on September 30, 1983. The Court of Appeals did not question its jurisdiction and decided the case on substantive grounds, as had the Tax Court.

STATUTES AND REGULATIONS INVOLVED

The statutes involved are Internal Revenue Code §§ 266, 274, 351, 358, 482, and 7701(a)(3), which are reproduced in the Appendix. The regulations involved are Treas. Regs. §§ 1.266-1,301.7701(2)-(a)(1) and (2) and 1.482-1, also reproduced in the Appendix. The constitutional issue is not based on a specific provision but on implications drawn from the entire Articles I and II, particularly Article I, Section 8, clauses 1 and 18, which are set forth in the Appendix.

STATEMENT OF CASE

1. This is an income tax case. Pe-

titioners appealed from an adverse decision the United States Tax Court reported in 80 T.C. 34. The Court of Appeals affirmed the Tax Court on all issues but one. The bulk of the original deficiency of $2,870,857 remains in issue.

2. Petitioners, referred to hereinafter either as "the Fosters" or as "the taxpayers", are husbands and wives who filed joint returns, except in one case where the husband died after the years involved and the petitioners are the estate of the decedent husband and the surviving wife. The four men were partners in T. Jack Foster & Sons and were the shareholders in several corporations which are not parties but are involved in the facts presented.

3. The facts found by the Tax Court and accepted below can be summarized as follows: Underlying the issues is the history of the development of Foster

City, a California city, from Brewer's Island, a 2600 acre partially submerged and barren area of San Francisco Bay in San Mateo County. The Foster partnership bought the land in that condition in August 1960, and evolved plans for its development into Foster City. In May, 1960 the California Legislature created Estero Municipal Improvement District as a political subdivision of the State, with authority and responsibility to issue tax-exempt bonds and impose property taxes, and with that financing to drain and fill Brewer's Island, to develop and improve it with the necessary facilities for a city, and to provide government for it. Estero was run by a board of directors, the members of whom were elected by the landowners, and a general manager it employed, who was unrelated to the Fosters. Initially the Fosters were the only landowners, but

from 1962, parts of Brewer's Island passed into other hands, taking those voting rights along.

4. The Foster partnership purchased Brewer's Island by making a $2,000,000 down payment and giving notes for the balance of the purchase price. The Fosters borrowed the down payment from the Republic National Bank of Dallas, Texas. To induce the bank to make the loan, they had offered the bank, in addition to interest, 50% of the profits when securely earned, in amount equal to the principal of the loans it would make or arrange. The offer and its acceptance were oral and never reduced to writing. The parties negotiated about the form profit-sharing would take, the bank insisting that its profit be taxable as capital gain.

The $2,000,000 loan to the Fosters was made by The Hoblitzelle

Foundation, at 6% interest, with one year maturity. The notes were renewed annually to August, 1963, when they were paid in full by proceeds from a loan from the Republic National Bank. Hoblitzelle Foundation was a charitable foundation organized by a former chairman of the board of the Republic Bank. In 1961 and 1962 the Fosters made installment payments totalling $1,000,000 to the previous landowners from other Republic Bank loans to them at 6% interest. By August, 1963 the Fosters owed Republic Bank $3,000,000 in interest-bearing notes.

The Fosters transferred 200 acres on Brewer's Island to a wholly-owned corporation, Foster Bayou Corp. ("Bayou"), on August 4, 1961. On August 7, 1962, the stock of Bayou was sold to Westway Investment Corp., ("Westway") for $105,000.00, of which $100,000 was

by promissory note. Westway was wholly owned by the Howard Corporation ("Howard") which in turn was owned by trustees for the shareholders of Republic National Bank. In January 1964 Westway wrote the Fosters, offering to sell the stock of Bayou for $3,105,000.00, with payment to be deferred. Esteroy Corporation ("Esteroy"), owned by the Fosters, accepted the offer. In May 1964 Esteroy signed notes in that amount and without interest, maturing serially in 1966 and 1967, and exchanged them with Westway for the Bayou stock.

Through transfers within the Foster group, the 200 acres became the property of Foster California Corporation in exchange for another Foster City tract of 196 acres and the Fosters assumed the $3,105,000 note. In their income tax returns reporting gains from the sale of lots in the 196-acre parcel, the Fosters

elected to capitalize the indebtedness as part of the cost of the 196 acres. The Commissioner disallowed that addition to basis. The propriety of his doing so is one of the major issues in this case.

5. Meanwhile, Estero had organized itself into a functioning municipal corporation. It employed a general manager who employed subordinates; it had a board of directors which met regularly, took necessary action, and kept minutes. The Fosters as landowners were free to elect directors of their own choosing, but to insure the independence of Estero they elected one Board member to represent them, the second was Estero's professional general manager, and the third was chosen by the San Mateo County Board of Supervisors. In 1962 Estero issued and sold the first of several series of tax-exempt bonds, pursuant to the enabling Act. It engaged an outside

engineering consultant, and adopted plans for municipal development. It hired third persons to drain, fill and level the acreage sequentially and to develop roads to the island, sidewalks, sewers, electricity and other utilities. It hired others to construct those improvements and an access bridge to the island, and a network of streets on the island, and a sewage plant, outfall line, and collection network. By October 3, 1962, some of these improvements were underway but none had been completed. Water had not been brought to the island, nor had the sewage disposal plant been built.

6. On October 3, 1962, 127 acres of Foster City land were conveyed by the partnership to four personal corporations, each owned by a partner; the names of each were derived from its shareholder's first name; e.g., Foster D Corporation for Richard H. (Dick) Foster. They

were referred to below as "the Alphabet corporations". In January 1963 these corporations filed a proposed subdivision map, together with the partnership, which had retained some land in the area to be subdivided. It was designated Neighborhood One ("N. One").

By May 1963, Estero's contractors had completed the access bridge, the water line, and the sewage outfall line. In July 1963, the sewage plant became operative, streets and sidewalks, and water, sewage, and gas systems, were completed in a portion of N. One, including the 127 acres which were subdivided into lots. In that month the four corporations made the first sale of lots in N. One. The Commissioner has allocated the entire proceeds from all sales of lots in the 127 acres to the Fosters under I.R.C. Section 482, and both the Tax Court and the court below

sustained this allocation "to prevent avoidance of income taxes." Both courts stated that the acts of Estero and its contractors to improve the lots should be attributed to the individual Fosters. This presents one of the major issues in this appeal.

7. Neighborhoods Two and Three ("N. Two and N. Three") were next completed, and they were sold by the partnership, beginning in late 1964 and continuing through the taxable years. The propriety of the inclusion of the Westway notes in the Fosters' basis for the property in Ns. Two and Three is an issue explained previously.

8. On August 29, 1966, the Foster family partnership transferred 311 lots in Neighborhood Four (N. 4) to Foster Enterprises, Ltd., ("Enterprises") a corporation owned by the partnership, which owned a subsidiary with 200 acres

in Foster City, and which also owned a Honolulu hotel which had incurred tax losses. The 311 acres were not salable when conveyed to Enterprises because they were not completely developed and improved; sales of fully improved lots in older areas in Foster City had come to a standstill; and Estero was unable to sell bonds due to pending litigation and was compelled to suspend operations at the end of 1966. Enterprises sold the first of the lots in February 1967.

The Commissioner allocated the entire proceeds from the sale of those lots to the Fosters individually. The Commissioner stated that the allocation of these proceeds from the sales of lots in N. One and N. Four was made "to prevent avoidance of income taxes," citing Section 482. The Tax Court and the court below both sustained his action for the reason he gave.

9. The Tax Court found that the transfers of the N. 1 lots were made to obtain the presumably lower corporate tax rate, although the partnership tax returns showed losses. The Tax Court also found that the transferee corporations were viable, that they held some of the transferred acreage for investment and leased it out, built apartment houses, and operated them. The Tax Court affirmatively held that they were not mere shells or sham.

Tax Court found that the transfer to Foster Enterprises was made to offset its tax losses from hotel operations, and rejected as untrustworthy the testimony of the Republic Bank officer then in charge of the account that he had demanded the transfer be made as the price of renewing the loans which came due in August 1966, and renewed the loans only when assured the transfer would be

made.

The Court of Appeals affirmed on both issues.

10. The Fosters each incurred business travel and entertainment expenses. In 1962 their office manager and their independent accountant jointly established a system to maintain and verify records to satisfy the requirements of newly enacted IRC Section 274. The system was administered by the office manager, Chase, who reviewed the records and prepared the tax returns in conformity to those records. The Revenue Agent in examining them disassembled the associated records and left them in that condition, so that the supporting bills and vouchers were detached and scrambled. He then asserted deficiencies based on disallowing some of the reimbursed expenses under Section 274. Neither Chase nor the outside accountant, Moak, could

reassemble the records. The agent's report did not identify which reimbursements were being disallowed as deductions and treated as income, and neither does the deficiency letter or the answer. It was impossible for anyone to discern the expenses disallowed.

At the trial, both Chase and Moak so testified. Chase also testified that he believed the system worked, that he returned claims unpaid which would not qualify under Section 274, whether made by a partner or by an employee, and that he approved on for inclusion in the tax returns only those which would be allowed. Moak testified that he made an independent sampling of the travel and entertainment account to be certain that it was operating as it should, and that it was he who prepared the tax returns and the deductions of travel and entertainment expenses from Chase's work

papers, only after satisfying himself in this manner that they were proper. He too stated that he considered that the system he helped install and reviewed should satisfy the requirements of Section 274, and the sampling determined that it was being administered in the intended manner. Moak also testified that during the conferences with the IRS Appellate Conferee he was given a copy of the agent's work papers pertaining to this issue, and that neither he nor the Conferee was able to comprehend them. A copy is in the record. Neither the trial judge nor respondent's counsel claimed to understand them. Respondent offered no testimony or other evidence to contradict or meet the thrust of the foregoing testimony. Nevertheless the trial court held that the Fosters had not carried their burden of proof because they had not identified the disallowed items and

showed that they were improperly disallowed, and the court below affirmed, stating the burden of proof in deduction cases was stronger than in gross income cases.

11. There are also two issues of evidence and procedure raised in the petition, in addition to the one concerning the propriety of discrediting Johnson's testimony, which we have described earlier. One such ruling prevented Jack Foster, Jr.'s testifying that at the time of trial he knew what the "business purpose" of the transfer to Enterprise was, the court stating that the existence of "business purpose" was the ultimate issue. Foster testified that when he gave a discovery deposition in 1971, which deposition the court had admitted into evidence, he had not known what the "business purpose" was and so testified, but that was before reading

Rex Johnson's testimony. He was not permitted to state whether he now knew of a business purpose. The result of the ruling coupled with the denial of our motion to strike his 1971 testimony was that Mr. Foster's testimony given in 1971 that he was ignorant of the business purpose of the transaction was in the record and was relied on by the Tax Court, and his explanation given at the trial, using the same terminology, has been excluded. The Court of Appeals did not discuss this issue, although we raised it in our briefs.

12. The final evidentiary point raised below is the ruling of the Tax Court that a pre-trial discovery deposition taken in a state court proceeding in 1969 is admissible under Fed. Rules of Evid., Rul. 804(b)(1), (5). This deposi- tion was given by Del Champlin, the since deceased financial

and tax adviser of the Fosters, who broke with them after the death of the senior Mr. Foster and brought suit against the surviving Fosters for $1,000,000 as a fee for tax advice and financial advice. The deposition was taken to learn what Champlin thought he had done to justify the fee. It was taken by the Fosters' attorney, there was no cross-examination, and the deposition was never used in the case, which was settled before trial. We appealed and briefed the admission of the deposition into evidence, but the court below did not discuss the issue.

13. Respondent obtained that deposition from the California Superior Court by subpoena, and also obtained in the same fashion a second deposition in a related proceeding by Champlin in 1971. In that deposition Champlin told an entirely different story in the two respects in which what he said is relevant,

and confirmed the testimony of the bank officer. Because we were taken by surprise by the suppression of the second deposition, and because we were concerned that our objection to admission of the first depositon would be waived if we offered a similar deposition into evidence ourselves, we did not do so. We lodged it with the Clerk of the Court of Appeals with the request that that court take judicial notice of the deposition under Rule of Evidence 201(b) and of the fact that in his second deposition Champlin testified inconsistently with what the Tax Court thought he said in the first one. The Court of Appeals refused.

REASONS FOR GRANTING THE WRIT

1.(a) In holding that Section 482 empowers the Internal Revenue Service to deny favorable tax incidents Congress has provided for, merely because the business structure taxpayers have adopted was chosen because of those tax incidents, the decision below is in conflict with the decision of the United States Court of Appeals for the Tenth Circuit in Keller v. Commissioner, 723 F.2d 58. That decision was addressed to the court below in our briefs and discussed at length as major point of reliance in our argument. The court below did not attempt to distinguish the Keller case but simply ignored it.

The principle involved in Keller is that involved here: Does Section 482 confer on the Internal Revenue Service the power to deny tax benefits Congress

has deliberately written into the tax code to effectuate its policies, merely because the taxpayer organized his affairs so as to obtain those benefits. In Keller, the taxpayer, a physician, formed a wholly owned professional corporation with which he contracted for his services, and it became the partner in the medical partnership in which he had theretofore practiced individually. He caused his corporation to establish a retirement fund and a medical insurance plan, which costs were deductible from the corporate net income but not taxable to him. If he had continued his practice in the partnership as an individual, he would have been restricted in the amount he could deduct from income for his retirement plan, and would have been taxable on the premiums paid for the medical insurance plan. Transforming his practice into corporate form therefor re-

duced taxes, which the Tax Court acknowledged he had intended. It held, nevertheless, that the tax code has consistently recognized the difference between corporations and individuals, and has consistently provided a different taxing structure for corporations than for individuals, always with a difference in rates. The Tax Court saw that Congress had deliberately invited what the physician had done and concluded that that amounted to a legislative mandate which the Commissioner could not ignore under the guise of allocation of income under Section 482. The Tax Court decision was reviewed by the entire court, with a majority opinion and numerous dissents. The Court of Appeals affirmed the Tax Court decision for the reasons set forth in the majority opinion. The reasoning of the two Keller courts is that found in the majority opinion of the

Tax Court, summarized above.

The issue in the instant case is the same in substance. As held in Keller, Congress has consistently provided for separate taxation of corporations and their individual stockholders, and the corporate income is taxed to the corporation instead of to the individual, at a different rate. The court below sustained the Tax Court decision that the transfer of property to corporations owned by the transferors, with knowledge which the Tax Court held the individuals had that the transfer, tax free under permissive Code sections, would serve to reduce taxes by having the income taxed to the corporations instead of to the individuals, was sufficient reason to allocate income to the transferors under Section 482 on the ground that the allocation served to prevent what that section describes as "evasion of taxes".

The decision below is thus in irreconcilable conflict with the Keller decision, unless the transferee corporations lacked substance or were shams.

However, Tax Court found here as it had in Keller that the transferee corporations had substance and did business. Here the corporations filed the subdivision map, they made numerous contracts for the development of the land occurring after the transfer of the land to them, and they made the sales to developers. The corporations ultimately invested the proceeds in apartments which they built and operated for several years, and they retained and leased out some of the land. In the last of the series of years involved the corporations owned and operated the apartment houses referred to. Though not identical factually, the cases are indistinguishable.

This conflict can have important

consequences if not corrected. By deciding the Keller case as a reviewed decision, the Tax Court meant to establish it as a rule of principle governing its future decisions. The decision in the Tax Court here was rendered after Keller, by a judge who had dissented in Keller. The affirmance of Keller after the Tax Court decision here has undoubtedly led the Tax Court to believe that the Keller decision was correct.

The inconsistent decision here is not only certain to confuse courts in future cases, but represents a true revolution in thinking. This is the first case in the long history of Section 482 to decide that an "evasion of tax" which the Commissioner can deny altogether flows from the necessary implication of Section 351, which is that the corporate tax rate applies to the income derived from the sale of property with the

carryover basis resulting from Section 351 transactions.[1/] Although the court below cited one of its former decisions (Rooney v. Commissioner, 305 F.2d 681 (1962)) as representing pre- existing precedent supporting that result, that case did not deny the benefits of Section 351 to the income from the transferred property, and, contrary to the instant case, did tax it to the corporate taxpayer instead of the individual shareholders. What it did was to sustain an allocation to the corpora- tion of the costs incurred to create the income of the corporation, so that the income and the cost of producing it would be taxed to the same taxpayer. The prior

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1/ Quite recently the Tax Court refused to sustain a Section 482 allocation to a parent in disregard of Section 351, saying: "It is well establilshed that taking advantage of tax benefits made available by Congress does not constitute tax evasion." Eli Lilly and Co., 84 TC 996, 1120 (1985). Here, though, both the Tax Court and the Court of Appeals held to the exact contrary.

decision is thus not precedent for what the court below did here, because neither it, nor the Tax Court, nor the Commissioner, assigned to the Fosters the costs incurred in improving the land to the point where it became saleable, and income productive. The instant decision is thus one without precedent.

The decision below must leave in doubt the tax status of every transaction complying with Section 351, since the conditions relied on by the Tax Court and by the Court of Appeals will be found in virtually every such transfer. Section 351 presupposes the transfer of appreciated property, and it requires that the transfer not change the beneficial control because it requires that the former owners of the property control the transferee corporation. Those are the very conditions the court below found triggered Section 482 in this case. If it

will do so in this case, it can trigger a reallocation under Section 482 in every case in which the Code imposes a lower tax on controlled corporations than on individuals.

(b) The decision below, in holding that taxpayers' deliberately taking advantage of tax reduction provisions is sufficient to authorize the Commissioner to invoke Section 482 to deny that tax reduction, is also in direct conflict with the decision of this Court in Commissioner v. First Security National Bank of Utah, 405 U.S. 394 (1972). That case is the only case this Court has decided which considered the application of Section 482. In his petition for certiorari there (Pet. Cert. No. 70-305, Oct. Terms 1970, 1971, p. 8), the Solicitor General asserted that in the restructuring which the Commissioner had attacked, "controlled corporate groups

sought to achieve considerable tax savings" through invoking the lower tax rates applicable to "the income of their life insurance subsidiaries.2/ The bank in question believed it could not legally receive referral income from insurance it originated for insurance companies. The restructuring it carried out created a reinsurance carrier affiliated with the bank which could legally receive premium income from the reinsurance of risks referred by the bank to insurance companies. The Commissioner allocated a portion of the reinsurance premiums to the bank for its services. In its opinion, this Court pointed out that the restructuring did indeed reduce taxes. (405 U.S. 394, 399.) It also added Footnote 4 to page 398 of the opinion, which has

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2/ In his brief on the merits (pp. 7, 27, 34), the Solicitor General also referred to the tax reduction consequent on the restructuring.

every earmark of being seriously intended, a quotation from Judge Learned Hand that the payment of taxes is an enforced exaction, not a voluntary contribution, and added its own words that "Taxpayers are . . . free to structure their business affairs . . . to minimize taxes." Since the Court was speaking in the context of Section 482, and addressing itself to a challenge the Solicitor General had made to the restructuring on the ground that it had been done to reduce taxes, the conclusion that the court meant what it said is irresistible. The lower court, however, referred to the language in the footnote as "shibboleth", and gave it no substance. Moreover it said, mistakenly, that the bank restructuring was not a "nonrecognition transaction." Even if that were true, it would not increase the Commissioner's power under Section 482,

unless the court meant that the Commissioner has more power to overturn Congressionally mandated "nonrecognition transactions" than transactions not governed by explicit tax deferral or minimization statutes.

The lower court's interpretation of this Court's decision in First Security Bank is erroneous and the error appears to us to be self-evident: There was no purpose for the Commissioner to apply Section 482 in that case unless by doing so he increased taxes by allocating income from a low bracket taxpayer to a high bracket taxpayer. Hence he had to contend that he was preventing the evasion of taxes through a restructuring which taxed some of the income at the lower insurance corporation rate. The questions whether the form of operation before the corporate restructuring was a violation of banking laws, and whether

that violation was cured by the restructuring, were not reached if the taxpayer's adoption of a restructuring which reduced taxes was sufficient to support a reallocation under Section 482 to "prevent evasion of taxes". This Court admitted that the effect of the readjustment was to reduce taxes (405 U.S. 394, 399) but in its Footnote 4 said that to reduce taxes by "lawful structuring" was every taxpayer's right. Only then did it need to question whether the Commissioner's allocation was proper under Section 482 "clearly to reflect the income," and it was in that context that the Court considered the banking law aspect of the case.

The Court of Appeals has entirely misread this Court's decision in First Security Bank, and has reduced its seriously meant remarks about taxpayers' right "to structure their business af-

fairs" to reduce their taxes, to a mere "shibboleth", by which the court evidently meant a slogan, and not a binding statement of principle.[3/] Failure properly to apply the only decision this Court has rendered involving Section 482 is a ground for granting the writ, and when coupled with the inconsistency between the decision below and that of the Court of Appeal for the Tenth Circuit in the Keller case, represents two important reasons for granting the writ. As we stated above, the importance of the issue in future administration of Section 482 is difficult to exaggerate.

3/ This Court subsequently applied the same principle to reject an attack on a sale and leaseback, Frank Lyon Co. v. United States, 435 U.S. 561 (1978). It had also declared that principle previously, in Gregory v. Helvering, 293 U.S. 465,469 (1935).

The foregoing is an important question of federal law[4/] which has not been but should be settled by this Court.

2. An important question of federal law which has not been, but should be, settled by this Court, is whether the authority to allocate income or deductions between controlled business entities "in order to prevent evasion of

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4/ The question is presented both by the transfers to the four corporations of lots in N. One, and the later transfers of 311 lots nearing the final stage of development for sale in N. Four to Foster Enterprises, a corporation owned by the individuals in equal shares. The ground offered to support the reallocations of both N1 and N4 lots was the same: the transfer was made to avoid or minimize taxes, and both courts sustained the reallocation on that basis. In so doing, they extended Section 482 to attain a result Congress stopped short of authorizing when it enacted Section 269.

taxes" extends also to allocations "to prevent avoidance of taxes." The Court below held that it did, without considering the constitutional limitation such a construction raises, although our briefs presented this point[5/]

The regulations, and both the Tax Court and the Court of Appeals in the instant case, have construed the language of Section 482 ("to prevent evasion of taxes") to have the same meaning as "to prevent avoidance of taxes." The Internal Revenue Code is replete with provisions carefully adopted by Congress ameliorate or reduce the burden of taxes on particular persons, on particular corporations, or on particular trans-

5/ The Commissioner's brief was silent on the point, a silence matched by the Court of Appeals.

actions. Virtually every one of those provisions becomes applicable only when the taxpayer acts, such as to form a corporation, which brings it into operation. Each act avoids taxes which would otherwise be imposed. Thus virtually every tax reduction or minimization provision Congress has placed in the Internal Revenue Code has the effect of "avoidance of taxes", so if the interpretation of the statutory term "to prevent evasion of taxes" means what the court below held it did, then everything done deliberately to take advantage of a tax minimization feature Congress has enacted will constitute "avoidance of taxes" within Section 482.

Section 482 becomes operative only when . . . "the Secretary . . . determines that such . . . allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations . . .." It is

thus dependent upon administrative discretion. However, under the interpretation below every tax minimization will evade taxes and may be denied by the Secretary, at his unfettered option.

Congress could not have intended to grant the Commissioner (the delegate of the Secretary) uncontrolled power to allocate income and deductions so as to tax income to corporations instead of individuals to produce greater taxes, or to individuals instead of corporations where that will, but the court below, and the regulations themselves, have so held. This represents an invalid delegation of power, but this so little disturbed the court below that it entirely failed to address our argument.

If the Commissioner has discretion to apply this axe to prune off all tax advantages Congress has enacted, he must be given guidelines for the exercise of

that discretion. If the statute means what it says, those guidelines will flow from the understandable difference between "evasion" and "avoidance." The flaw in the reasoning below (and in the regulations) is the equation of "evasion" and "avoidance." This is more than a matter of improper statutory interpretation. If the statute may be applied wherever what the taxpayer has done is to avoid taxes, and the Commissioner can invoke the statute as he sees fit, Congress has delegated to him the power to deny every tax rate minimization feature in the Internal Revenue Code which it adopted, where there are the controlled or related entities or parties many of the tax minimization sections require. This violates the delegation of powers principle declared in Schechter v. United States, 295 U.S. 495 (1935), and Pacific Refining Co. v. Ryan, 293 U.S.

386 (1935), and the separation of powers doctrine recently applied by this Court in I. N. & S. v. Chadha, ___ U.S. ___, 77 L.Ed.2d 317 (1983).

Unlike the Court of Appeals, the Tax Court did consider and reply to this contention to its satisfaction, by stating in reliance on a law review article and a dissenting opinion by a member of this Court that the first two of those cases had been overruled by the passage of time.

We suggest that awareness by this Court of the existence of this problem is suggested by the fact that in its opinion in Commissioner v. First Security Bank of Utah, supra, 405 U.S. 394 (1972), this Court referred to the statutory word "evasion", and never once referred to it as "avoidance."

The question is important and underlies every use of Section 482 to negate

Congressionally enacted tax avoidance measures.

3. In holding that the principal of the Westway notes constituted interest, the Court of Appeals has decided another federal question in a way to conflict with this Court's decision in Deputy v. duPont, 308 U.S. 488 (1940). Its decision also conflicts with this Court's decision in United States v. Mississippi Chemical Corp., 405 U.S. 298 (1972), and with its decision of the second aspect of Commissioner v. First Security Bank of Utah, supra, 405 U.S. 394 (1972).

The status of the notes as interest or principal would not matter if the taxpayers were permitted to capitalize them under Internal Revenue Code Section 266, as they elected to do. Both lower courts held that that section was unavailable to a cash basis taxpayer. The language of the statute does not com-

pel that discrimination, and the legislative history, which we analyzed in our brief below, refutes the suggestion.

If the "Westway Notes" constituted interest, (1) they were usurious and hence violated the law of Texas, where the obligee did business, (2) they were interest on a liability to repay funds the obligee had never advanced or loaned, and (3) were never payable to the entities which did lend funds. The funds were loaned by the Hoblitzelle Foundation, a charitable foundation, and after three years were repaid with funds borrowed from the Republic National Bank. Westway, to which the $3,000,000 of notes were payable, was neither parent nor subsidiary of the Republic National Bank, although the Bank and Westway's parent had common shareholders. For an interest obligation to exist, as this Court has defined the rule, there must be a princi-

pal obligation to repay a debt to the one to whom interest is payable, and to repay it in cash. Deputy v. duPont, supra, 308 U.S. 488. 497-498. This essential element was missing. This is a question of law, not fact. United States v. Mississippi Chemical Corp., supra. Moreover, the concept of "interest" approved below is indeed "esoteric" and not one based on the "usual, ordinary and everyday meaning of the term," as Deputy v. duPont requires, supra, 308 U.S. at 497.

The genesis of the obligation was an oral agreement between the Fosters and the Republic National Bank to give the bank a 50% interest in the profits up to an amount equal to the funds the bank either loaned or persuaded someone else to lend to the Fosters, This is a form of inducement known in business as a "piece of the action." The regulations of the Comptroller of the Currency permit a

national bank to take such an inducement, either in lieu of interest or in addition to it. 12 C.F.R. 7.7312. The loans made by the Hoblitzelle Foundation and later by the bank bore interest at the rate of 6%, which was the going rate of interest at the time. Hence the inducement was in addition to interest, not in lieu of it.

By letter ruling, the Comptroller of the Currency has ruled that the amount, if in lieu of interest, cannot be large enough to make the transaction usurious. Since the additional amount was 100% of the loan, if it was interest it was obviously usurious, and the Tax Court acknowledged the fact in its opinion. Once again two courts have approved the Commissioner's action in distorting a transaction from a legal form into an illegal one, in order to increase taxes. This interpretation of the Commissioner's powers was disapproved by this court in

Commissioner v. First Security Bank of Utah, supra, 405 U.S. 394, in the context of Section 482. On this issue, the Commissioner has not used Section 482. Instead, he has relied on his interpretation of the substance of the transaction, which was sustained by the courts below as if it were a question of fact. However, the rule that the Commissioner should not distort legal transactions into illegal ones in order to produce a larger tax is a rule of law.

As we stated above, the court below decided the issue in a manner which conflicts with the decision of this Court in United States v. Mississippi Chemical Corp., supra, 405 U.S. 298, where, in reversing two lower courts which had treated as one of fact the question whether certain payments were interest so as to be deductible, this Court held that the amounts in question were not inter-

est. In the course of its opinion the Court stated that where the form of a transaction was carefully and deliberately adopted for reasons of the parties, the form should not be lightly disregarded and amounts treated as interest contrary to the parties' contract, particularly when the payments are not interest in the ordinary sense of the word, relying on Deputy v. duPont, supra.

We submit that the Court of Appeals, as did the Tax Court, has gone to unreasonable lengths to disregard the form of the transaction, and even identity of the parties. No principal sum was ever owed to Westway, except the notes themselves, and the principal of the notes could not possibly be interest, under the rules of this Court as discussed above, and if the transaction is related to its inception and the negotiations of the parties which produced it, and the amounts are treated

as interest, they amount to 100% of the loan and hence are usurious and unlawful, with the result that the transaction has been distorted by the court below and the Commissioner into an illegal form, contrary to this Court's decision in First Security Bank of Utah decision.

The question of what is interest is always important in tax administration and in denying that the thousands of cash basis taxpayers who must have elected to capitalize under Section 266 did so properly, the court below has opened a Pandora's box which represents an important question of federal law, appropriate for review here.

4. The court below has so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision.

(a) The court below disregarded the

existence of three sections of the new Rules of Evidence, which were adopted in 1978 and therefore applied to this case. All three were discussed at length in our briefs, though not all of them were discussed in appellee's brief. These are Rule 301, governing the survival of presumptions; Rule 804(b)(1) and (5), dealing with the admissibility of discovery depositions taken in a state court proceeding between private parties involving different issues; and Rule 201 dealing with the mandatory requirement that the court take judicial notice of proper items for judicial notice when called to the court's attention. Not one of the three was discussed by the Court of Appeals, but statements or actions in conflict with them were made.

Rule 301 provides that presumptions disappear when evidence making a prima facie case has been introduced. It

does not distinguish between the many presumptions of official regularity, and presumptions between private parties; it does not distinguish between presumptions in a tax case where the issue is a deduction, and where the issue is over gross income. Nevertheless, the court below, citing a previous decision of its own antedating the adoption of the Rules of Evidence, and without discussing either the relevant section of those rules, or this Court's decision in Helvering v. Taylor, 293 U.S. 507 (1935), held that the presumption continued in effect after a prima facie case was made by the taxpayers because the issue was the propriety of a deduction, and an especially heavy burden is on the taxpayer to establish his right to deductions. That distinction is not made by Rule 301.

The underlying issue was whether petitioners had complied with Section

274, which requires certain types of documentary support for travel and entertainment deductions. The deficiency letter merely disallowed a lump sum, without specification. The examining Revenue Agent had scrambled petitioner's records so that it was impossible for anyone to determine which items were disallowed. His work papers were undecipherable, as the trial judge noted during the trial. Petitioners' uncontroverted evidence showed that the system provided the necessary documentary support, including random examples taken from their files. These examples met the Section 274 standard (which neither court denied), making a prima facie case, and the Commissioner should have been required to produce evidence showing which deductions were disallowed, and why. He stood mute. Under the new Rule there was no remaining presumption in his favor and

judgment on this issue should have been for petitioners, but both lower courts held, the Tax Court with an opinion explaining its views but disregarding the Rule, and the Court of Appeals without discussing the new rule, that the presumption survived. On this point the decision below is contrary not only to Rule 301 but to the decision of this Court in Helvering v. Taylor, 293 U.S. 507 (1935), where the issue was the proper calculation of basis to be deducted from sales price. It appears also to be an attempt to limit United States v. Janis, 428 U.S. 433 (1976), where nothing said by this Court suggests any distinction between gross income cases and deduction cases.

The next omission by the court below from accepted and usual course of judicial proceedings was its refusal to discuss and decide whether a pre-trial dis-

covery deposition taken in a state court proceeding between different parties was admissible in evidence as an exception to the hearsay rule under Rule of Evidence 804(b)(1) and (5). The Tax Court had admitted it over our objections. This point was thoroughly discussed in our briefs but the court below did not respond to our argument either by rejecting it or agreeing with it, though the effect of its affirmance is to leave the trial court unreversed for having admitted the discovery deposition in evidence and having relied on it extensively.

Allied to this objectionable silence is the court's silence about its reason not to follow the mandate of Rule 201 and take judicial notice of a second and conflicting pre-trial discovery deposition given by the same witness in the same court. Rule 201(d) states that the obligation to take judicial notice is

mandatory at any stage in the case, if the offered material satisfies the requirements for judicial notice and is made available to the court by the offering party. We did this. This particular deposition was subpoenaed by the Commissioner from the files of the Superior Court of California for San Mateo County, was made returnable to the Tax Court in San Francisco, was presented to the Tax Court, but was not offered in evidence by the Commissioner, whose attorney told the Tax Court that it was cumulative of the first deposition. We offered the second deposition for judicial notice in the Court of Appeals to prove that the witness had testified differently in the second deposition, on a point the Tax Court had extracted from the first deposition and on which it had placed much emphasis. We argued both that the inconsistency of the two depositions demon-

strates the inherent unreliability of discovery depositions, and that if the depositions are admissible, the Commissioner should not profit from his suppression of the second deposition on a misrepresentation to the trial court, and there should be a remand for a trial at which both depositions would be considered. The Court of Appeals was silent on all these points, not even demonstrating that it had considered them, or understood them.[6/]

(b) The Court of Appeals also departed from the accepted and usual course of judicial proceedings in refusing to remand for a new trial where the

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6/ The Court of Appeals treated our motion to take judicial notice as a motion to augment the record, and as such denied it, saying: "The deposition is not properly before this court, . . ." Footnote 2 to opinion, Appendix infra p. i. We brought it before the court exactly as Rule 201 prescribes.

suppressed evidence could be considered. In his briefs in the Tax Court, Commissioner asked that court to make findings which were contradicted by the suppressed evidence, although his counsel had represented it was merely cumulative. That court made those findings, over our objections that the deposition was hearsay and not made admissible by Rule 804(b)(1), and did not say what was argued. We would have waived the first objection had we offered the second deposition because it was not admissible if the first one was not. In both our briefs and our petition for rehearing in the Court of Appeals we cited decisions from this Court holding that a new trial must occur under the compulsion of the due process clause where at the first the Government suppressed evidence (Giglio v. United States, 405 U.S. 150 (1972)), or knowingly introduced perjured testimony

(Napue v. Illinois, 360 U.S. 264 (1959)). We pointed out that the due process clause is a guaranty to property as well as liberty so it applies to civil cases as well as criminal (Parratt v. Taylor, 451 U.S. 527, 537, 538, (1981)).

We also pointed out that we had not waived objections to the suppression of the deposition because we were contending that such depositions were inadmissible.

Not only did the Court of Appeals not remand for a new trial but it neglected to explain why or discuss the issue at all. This is a departure from settled judicial procedure producing an unconstitutional result, and hence is particularly worthy of the exercise of this Court's supervisory powers.

(c) Another argument the court below ignored was that the trial court erred in refusing to permit one of the

parties to testify that he now knew what the business purpose was for the transfer of N. 4 to Foster Enterprises. In a deposition in a prior case in the state courts, admitted by the Tax Court, he had testified to ignorance of the business purpose. The Tax Court refused to permit him to correct his testimony by using the same phrase, business purpose, he had used in the prior testimony. Obviously, if he could not use the term he used before, his correction would not be any correction at all. The error was so clear respondent did not even argue to justify it in his brief below, but the court below did not reverse on that account; it ignored the point. This too is a departure from the accepted and usual course of judicial proceedings.

(d) The court below departed from established law by improperly treating the activities of Estero Municipal

Improvement District, a public agency of the State of California, created by the State Legislature, as those of the taxpayers, and improperly held that increases in land values due to improvements made by Estero's employees and independent contractors and financed by public funds should be treated as made by these taxpayers. In addition, the court held that the taxpayers' corporations that employed them and paid them salaries for their services should be disregarded as well, and all the taxpayers' activities should be treated as if conducted by them as individuals in order to increase the value of the property held by various of their corporations, and not as corporate employees. In this fashion the court sought to justify the application of Section 482 to tax the individuals on the increment in value of land before the corporations sold it because of the im-

provement of the land by the State of California's agency, Estero.

To sweep aside corporate entities in this manner is such a departure from the accepted and usual legal standards as to call for the exercise of this Court's power of supervision. This court has repeatedly held that the corporate fiction is created by law and is meant to be recognized, in tax matters as elsewhere (Klein v. Board of Supervisors, 283 U.S. 19 (1930); Moline Properties, Inc., v. Commissioner, 319 U.S. 436 (1943), unless abused. No abuse was found here, or existed. Estero did exactly what the California legislature created it to do, and in a proper manner. The California Supreme Court so held. Cooper v. Estero Municipal Improvement District, 70 Cal.2d 645, 75 Cal.Rptr. 777 (1969), cert. den. 396 U.S. 821; Cooper v. Leslie Salt Co., 70 Cal.2d 627, 75 Cal.Rptr. 766 (1969).

To attribute its activities to the Fosters is to disregard the legal separateness of the state agency, even though the court below thought it could successfully deny that analysis. It distinguished its prior decision in Commissioner v. Birch Ranch & Oil Co., 192 F.2d 924 (9th Cir., 1951), although the distinction appears empty. It could overrule that decision without presenting a conflict between the circuits, but if it did that there would remain a conflict between this case and that in Rutland v. Tomlinson, 327 F.2d 668 (5th Cir. 1964), which followed the Birch decision. To the Fifth Circuit it must appear that there is a conflict.

The disregard by the court below of the existence of the controlled private corporation T. Jack Foster and Sons, Inc., so it could attribute the activities of the Fosters (and others) as

employees of that corporation to the Fosters individually is also startling, and has more widespread precedential impact. There was no evidence in the record that the Fosters abused or disregarded the corporate identity. The record showed the corporation was one of substance which owned several buildings in Foster City. The Commissioner did not allocate income or deductions to or from it under Section 482, he allocated employees from it, and the court below sustained him on the ground the Fosters used the corporation in their business. That is the classic reason closely held corporations are formed, and if their identity can be disregarded on that ground as the court below did, the decision below is revolutionary, contrary to established concepts of law, and should not be allowed to stand.

The decision presents an important

question of federal law which apparently has been left open by prior decisions of this Court. That question should now be settled by this Court.

(e) The Court of Appeals also failed to follow the accepted course of judicial procedure by not addressing petitioners' alternative argument that if they, as taxpayers, were chargeable with the activities of the staff of Estero Municipal Improvement District, and with borrowing funds in its name, contracting in its name, placing improvements on Brewer's Island in its name, then they were engaged in business as an association taxable as a corporation. Estero was a corporation; it differed from the typical in that voting power was in landowners and not shareholders, and petitioners had the majority of votes; this is the hook on which the court hung its conclusion that petitioners used

Estero's employees and taxing power and borrowing power to construct the improvements on Brewer's Island which improved and increased the value of their land. It follows from the court's analysis that petitioners did business as an association, because they utilized all of the corporate characteristics of Estero, as well as those of the private corporation, T. Jack Foster & Sons, Inc., which was their employer. Thus petitioners surrounded themselves with corporate characteristics and used them in their activities.

This scenario creates the classic association, under the Regulations (Treas. Reg. Section 301.7701-2(a)(2), last sentence, ibid, subdivision (b)(1), (c)(1) and (3), (d)(1) and (e)(1)), under Bert v. Helvering, 92 F.2d 391, (D.C. Cir. 1937), and under this Court's decision in

Morrissey v. Commissioner, 296 U.S. 344 (1935), and a number of similar cases decided the same day as Morrissey. This position, if sound, would have won the entire case for petitioners, because it would have meant that the assessments made against petitioners should have been made against the association, against which the statute of limitations has apparently run.

The Court of Appeals should be instructed to consider and decide this and the other issues it ignored.

CONCLUSION

The writ of certiorari should be granted.

Respectfully submitted,

Valentine Brookes
Counsel of Record
Lawrence V. Brookes
BROOKES AND BROOKES
Attorneys for Petitioners

(Appendices follow)

APPENDICES

I and II

No. 85-

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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1985

RICHARD H. FOSTER AND SARA B. FOSTER, T. JACK FOSTER, JR., AND PATRICIA FOSTER, JOHN R. FOSTER AND CAROLINE FOSTER, AND ESTATE OF T. JACK FOSTER, DECEASED, GLADYS H. FOSTER, EXECUTRIX, AND GLADYS H. FOSTER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

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Appendix I

Constitutional provisions, statutes, and regulations involved

Appendix

A-1

United States Constitution,

Article I,

Sec. 8.[Powers of Congress.]

[1.] The Congress shall have power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.

[18.] To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.

SEC. 266. CARRYING CHARGES.

No deduction shall be allowed for amounts paid or accrued for such taxes and carrying charges as, under regulations prescribed by the Secretary, are chargeable to capital account with respect to property, if the taxpayer elects, in accordance with such regulations, to treat such taxes or charges as so chargeable.

SEC. 351. TRANSER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

(b) Receipt of Property.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received, and

(2) no loss to such recipient shall be recognized.

(c) Special Rule.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

(a) General Rule.—In the case of an exchange to which section 351, 354, 355, 356, 361, 371(b), or 374 applies—

(1) Nonrecognition Property.—The basis of the property permitted to be received under such section without

the recognition of gain or loss shall be the same as that of the property exchanged—

(A) decreased by—

(i) the fair market value of any other property (except money) received by the taxpayer,

(ii) the amount of any money received by the taxpayer, and

(iii) the amount of loss to the taxpayer which was recognized on such exchange, and

(B) increased by—

(i) the amount which was treated as a dividend, and

(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

(2) Other Property—The basis of any other property (except money) received by the taxpayer shall be its fair market value.

(b) Allocation of Basis—

(1) In general—Under regulations prescribed by the Secretary, the basis determined under subsection (a)(1) shall be allocated among the properties permitted to be received without the recognition of gain or loss.

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SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or busi-

nesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

TREASURY REGULATIONS

§ 1.266-1. Taxes and carrying charges chargeable to capital account and treated as capital items.

(a) In general. In accordance with section 266, items enumerated in paragraph (b) (1) of this section may be capitalized at the election of the taxpayer. Thus, taxes and carrying charges with respect to property of the type described in this section are chargeable to capital account at the election of the taxpayer, notwithstanding that they are otherwise expressly deductible under provisions of subtitle A of the Code. No deduction is allowable for any items so treated.

(b) Taxes and carrying charges. (1) The taxpayer may elect, as provided in paragraph (c) of this section, to treat the items enumerated in this subparagraph which are otherwise expressly deductible under the provisions of subtitle A of the Code as chargeable to capital account either as a component of original cost or other basis, for the purposes of section 1012, or as an adjustment to basis, for the purposes of section 1016(a)(1). The items thus chargeable to capital account are—

(i) In the case of unimproved and unproductive real property: Annual taxes, interest on a mortgage, and other carrying charges.

(ii) In the case of real property, whether improved or unimproved and whether productive or unproductive:

(a) Interest on a loan (but not theoretical interest of a taxpayer using his own funds),

(b) Taxes of the owner of such real property measured by compensation paid to his employees,

§ 1.482-1. Allocation of income and deductions among taxpayers.

(a) *Definitions.* When used in this section and in § 1.482-2—

(1) The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations thereunder), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The term "trade" or "business" includes any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise.

A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms "group" and "group of controlled taxpayers" mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done,

and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(2) Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return."

(3) Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions. It is not intended (except in the case of the computation of consolidated taxable income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated taxable income under subchapter A, chapter 6 of the Code.

(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director

is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(d) *Method of allocation.* (1) The method of allocating, apportioning, or distributing income, deductions, credits, and allowances to be used by the district director in any case, including the form of the adjustments and the character and source of amounts allocated, shall be determined with reference to the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income. The appropriate adjustments may take the form of an increase or decrease in gross income, increase or decrease in deductions (including depreciation), increase or decrease in basis of assets (including inventory), or any other adjustment which may be appropriate under the circumstances. See § 1.482-2 for specific rules relating to methods of allocation in the case of several types of business transactions.

(2) Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as "primary" adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustment shall actually be made if the United States income tax liability of the other member would be affected for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only

increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the United States income tax liability of the other member for any pending taxable year. For the purposes of this subparagraph, a "pending taxable year" is any taxable year with respect to which the United States income tax return of the other member has been filed by the time the allocation is made, and with respect to which a credit or refund is not barred by the operation of any law or rule of law. If a correlative adjustment is not actually made because it would have no effect on the United States income tax liability of the other member involved in the allocation for any pending taxable year, such adjustment shall nevertheless be deemed to have been made for the purpose of determining the United States income tax liability of such member for a later taxable year, or for the purposes of determining the United States income tax liability of any person for any taxable year. The district director shall furnish to the taxpayer with respect to which the primary adjustment is made a written statement of the amount and nature of the correlative adjustment which is deemed to have been made. For purposes of this subparagraph, a primary adjustment shall not be considered to have been made (and therefore a correlative adjustment is not required to be made) until the first occurring of the following events with respect to the primary adjustment:

• • •

(4) If the members of a group of controlled taxpayers engage in transactions with one another, the district director may distribute, apportion, or allocate income, deductions, credits, or allowances to reflect the true taxable income of the individual members under the standards set forth in this section and in § 1.482-2 notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period. For example, if one member of a controlled

group sells a product at less than an arm's length price to a second member of the group in one taxable year and the second member resells the product to an unrelated party in the next taxable year, the district director may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, notwithstanding that the second member of the group had not realized any gross income from the resale of the product in the first year. Similarly, if one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year. The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members.

(5) Section 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied in circumstances described in sections of the Code (such as section 351) providing for non-recognition of gain or loss. See, for example, *National Securities Corporation v. Commissioner of Internal Revenue,* [43-2 USTC ¶ 9560] 137 F. 2d 600 (3rd Cir. 1943), cert. denied 320 U. S. 794 (1943).

§ 1.482-2 Determination of taxable income in specific situations.

§7701. DEFINITIONS

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof--

. . . .

(3) CORPORATION--The term "corporation" includes associations, joint-stock companies, and insurance companies.

No. 85-

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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1985

RICHARD H. FOSTER AND SARA B. FOSTER, T. JACK FOSTER, JR., AND PATRICIA FOSTER, JOHN R. FOSTER AND CAROLINE FOSTER, AND ESTATE OF T. JACK FOSTER, DECEASED, GLADYS H. FOSTER, EXECUTRIX, AND GLADYS H. FOSTER,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

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Appendix II

Opinion of Court of Appeals for the Ninth Circuit, and Order denying rehearing

F I L E D
APR 3 1985
PHILLIP B. WINBERRY
CLERK, U. S. COURT
OF APPEALS

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

RICHARD H. FOSTER AND SARA B. FOSTER, T. JACK FOSTER, JR. and PATRICIA FOSTER, JACK R. FOSTER and CAROLINE FOSTER, and Estate of T. JACK FOSTER, Deceased, GLADYS H. FOSTER, Executrix, and GLADYS H. FOSTER,	No. 83-7745 Tax No. 1717-78
Petitioneers-Appellants,	OPINION
vs.	
COMMISSIONER OF INTERNAL REVENUE,	
Respondent-Appellee.	

Appeal from the Decision of the
United States Tax Court
Argued and submitted November 16, 1984

Before: DUNIWAY, KENNEDY, and ANDERSON,

Circuit Judges.

J. BLAINE ANDERSON, Circuit Judge:

In 1955, Jack Foster and his three sons formed a partnership, T. Jack Foster

and Sons (Partnership), for the general purpose of dealing in property, with Jack as the managing partner. In 1958, the Partnership began to investigate the reclamation potential of Brewer's Island, a 2,600 acre undeveloped and partially submerged tract of land located about 12 miles south of San Francisco. After commissioning engineering studies, the Partnership determined that the tract could be transformed into a self-contained city (Foster City) of 35,000.

In December, 1959, the Partnership acquired an option to purchase the property for $12.8 million; in May, 1960, it secured enabling legislation from the California legislature for a municipal improvement district known as Estero, which was coterminus with Brewer's Island; and, in August, 1960, it exercised its option to purchase the tract. Thereafter, the Partnership and Estero began developing the property by

neighborhood.

The Commissioner of Internal Revenue issued notices of deficiency to the Fosters for the years 1963-67 concerning their role in the development of Foster City. The Fosters appeal the United States Tax Court's affirmance of the Commissioner's determination. We affirm in part and vacate in part.

I. Section 482

The Internal Revenue Code of 1954, §482, 26 U.S.C. §482 (1976), authorizes the Commissioner to reallocate income or deductions among commonly controlled businesses "if he determines that such . . . allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such . . . businesses."

A. Standard of Review

In §482 cases, this court has held that "[t]he Commissioner has broad

discretion under section 482, and neither we nor the Tax Court will countermand his decision unless the taxpayers shows it to be unreasonable, arbitrary or capricious." Erickson v. Commissioner, 598 F.2d 525, 528 (9th Cir. 1979).

The Fosters argue that this standard was diluted in Commissioner v. First Security Bank of Utah, 405 U.S. 394 (1972), in which the Court concluded that "[t]he Commissioner's exercise of his § 482 authority was therefore unwarranted in this case." 405 U.S. at 407. We do not believe the Court, by employing the term "unwarranted," was signaling a change in the standard of review. The issue before the Court was not the appropriate standard of review. Moreover, the Court was affirming the determination of the Tenth Circuit, which had employed the arbitrary and capricious standard in reaching its decision. See First Security Bank of Utah, N.A. v.

Commissioner, 436 F.2d 1192, 1198 (10th Cir. 1971).

B. The "Avoidance" of Taxes

Section 482 refers to the "evasion of Taxes," whereas the Tax Court based its decision on the Fosters' "avoidance of taxes." We have noted the "sometimes elusive" distinction between the two terms, Stewart v. Commissioner, 714 F.2d 977, 9876 (9th Cir. 1983), and agree with the Tax Court's finding that "for purposes of Section 482, a non-punitive section, the terms are interchangeable." Foster v. Commissioner, 80 T.C. 34, 158 (1983).

The regulations support the Tax Court's holding.[1] Additionally, this court, in discussing the application of § 482, has stated that "Congress enacted the predecessor of section 482 to prevent the evasion of taxes through such means as 'shifting of profits, the making of fictitious sales and other methods

frequendtly adopted for the purpose of "milking."'" Stewart, 714 F.2d at 987 (citations omitted). Put another way, the taxpayer must establish that he did not "cash in" on the gain. Id. at 989. In a civil case, a thorough analysis of the facts in light of the above criteria is more important than whether the Tax Court labeled its ultimate conclusion tax avoidance or evasion.

Our conclusion is not altered by Commissioner v. First Security Bank of Utah, 405 U.S. 394 (1972), in which the Court reiterated the long-standing shibboleth that a taxpayer is free to arrange his affairs in the manner calculated to minimize his tax liability. 405 U.S. at 398 n.4. In First Security, the Court disapproved the Commissioner's reallocation under § 482. First Security, however, did not, as in this case, involve a nonrecognition transaction. Also, the determinative

factor in disallowing the reallocation was that it would have been illegal for the entity to receive the income, id. at 401-402, which is not the situation here.

C. Application of § 482 to the Disposition of Property Acquired in a Nonrecognition Transaction

The first of the nine neighborhoods to be developed was Neighborhood One. In October, 1962, before any sales to builders were consummated, the Partnership transferred an undivided one-quarter interest in 127 acres of Neighborhood One to each of four newly formed corporations as tenants in common. Each of the four corporations, referred to collectively by the Tax Court as the Alphabets, was solely owned by one of the Fosters.

In August, 1966, the Partnership transferred 311 lots in Neighborhood Four, which had been improved to a lesser extent than Neighborhood One, to Foster

Enterprises, a corporation owned by the Fosters in equal shares. Foster Enterprises, which was incorporated in 1960 to take title to a hotel in Hawaii, had accumulated a net operating loss of $1.2 millions.

The Neighborhood One transaction was an exchange of property for stock under §351. The Neighborhood Four transaction was a contribution to capital under § 1032. Under both sections, neither the tranferor nor the transferee recognize gain or loss on the transfer, and the basis of the property does not change. The transferee therefore inherits the potential gain or loss inherent in the property at the time of its transfer.

The Tax Court was correct in its determination that the Commissioner may employ §482 to reallocate income derived from the disposition of property previously acquired in a nonrecognition transaction. Rooney v. United States,

305 F.2d 681, 686 (9th Cir. 1962) (Section 482 will control when it conflicts with § 351 as long as the discretion of the Commissioner in reallocating is not abused.); Treas. Reg. § 1.482-1(d)(5) (1984); see also Stewart v. Commissioner, 714 F.2d 977, 989 (9th Cir. 1983).

D. Section 482 Reallocation

The Tax Court, pursuant to § 482, reallocated all the income from the sale of the lots in Neighborhood One and Neighborhood Four from the Alphabets and Foster Enterprises to the Partnership. The income reallocated was divided into two parts, income due to appreciation in value before the transfers and income due to appreciation after the transfers.

1. Pre-transfer Appreciation

The Tax Court reallocated the income attributable to appreciation before the transfers on the ground that the purpose of the transfers was to avoid

taxes. It found that A.O. Champlin, the Fosters' long-time tax advisor, decided it was advantageous from a tax standpoint for the Fosters to undertake the development of Foster City in a partnership form. Losses incurred during the early years could then be used by the partners to reduce income on their personal tax returns. Later, as the land was developed, certain lots were transferred from the Partnership to its controlled entities in an effort to shift income. As noted by the Tax Court, "only highly appreciated inventory pregnant with income was conveyed." Foster, 80 T.C. at 179. Moreover, according to the testimony of Champlin, the value of money on hand to the Fosters far exceeded any interest that might eventually have to be paid on a tax deficiency, particularly when the rate of interest charged by the Government was less than that charged by commercial banks.

In the case of the Alphabets, which were formed within a month of the transfer, the Tax Court determined that the object was to shift from the Partnership the income from the sale of the lots and split it among taxpayers subject to a lower rate of tax. The Fosters argue that the transfer could not have been tax motivated because it would have increased taxes; the income reported by the Alphabets was not offset by any losses, whereas if the income had been reported by the Partnership, it would have been offset by the operating losses which the Partnership claimed on its returns. The Tax Court, however, found that "the tax savings to an individual realized by preserving a partnership loss may very well exceed the tax cost to his corporation incurred by reporting the income." Id., 80 T.C. at 173.

The Fosters contend that although the Neighborhood Four transfer

may have resulted in a tax saving, it was made for a business purpose. There was evidence that Rex Johnson, a senior vice president of Republic National Bank who was in charge of monitoring the Foster's account, insisted that the lots be conveyed to Foster Enterprises as a condition to Republic's renewing the Partnership's loans. The Tax Court discounted this as the motivation behind the transfer, and we find its reasoning persuasive.

Foster Enterprises was not indebted to Republic. It had borrowed money from Likins-Foster Honolulu Corporation and Roy Turner Associates, Ltd., a subsidiary of Likins-Foster. Both Likins-Foster and the Partnership were indebted to Republic.

According to Johnson, the transfer was necessary to improve the liquidity of Foster Enterprises and thereby (1) enhance the collectibility of

the indebtedness of Likins-Foster to Republic, (2) improve the bank's security in the Likins-Foster stock, and (3) insulate the bank from the fortunes of the Foster partnership. The Tax Court, however, found that a special audit report prepared by the bank stated that the Likins-Foster loans were being paid according to schedule. Moreover, if Johnson were concerned about the ability of Likins-Foster to repay its loan, it would have made more sense to transfer the lots directly to that corporation because it was the Likins-Foster stock that had been pledged as security. The transfer of the lots obviously weakened the Partnership's ability to repay its loan to Republic, noted the Tax Court, and certainly exacerbated its cash flow problem.

The sales proceeds were not used by Foster Enterprises to liquidate its debts to Likins-Foster and Turner

Associates. Rather, they were loaned to the Partnership to further develop Foster City. Although Foster Enterprises still had an asset, it was now, continued the Tax Court, an unsecured receivable from the Partnership. Collectibility was therefore dependent upon the Partnership's overall success with the Foster City undertaking, precisely the risk against which Johnson ostensibly wanted to protect.

The Tax Court found that the purpose of the Neighborhood Four transaction was to shift to Foster Enterprises the income earned from the sale of the lots so that it could be absorbed by that corporation's losses. The record contains ample evidence to support the Tax Court's conclusions concerning both the Neighborhood Four and the Neighborhood One transactions.[2] We therefore find that the Commissioner did not abuse his discretion in reallocating

to the Partnership that portion of the sales income due to appreciation before the date of transfer. See Rooney v. United States, 305 F.2d 681, 684-85 (9th Cir. 1962).

2. Post-transfer Appreciation

Because Neighborhoods One and Four were both further developed after the transfers, a part of the income derived from the sale of lots was created after the transfer date. The Tax Court concluded that Estero was controlled by the Partnership, and was used by it as its instrument for the development of Foster City. Thus Estero's efforts were to be viewed as those of the Partnership, and the gain was to be attributed to it.

Estero, a Municipal Improvement District, was created in 1960 by a special act of the California legislature. It was authorized to tax and to issue tax-exempt bonds to finance its activities in reclaiming and

improving Brewer's Island. It was also vested with a broad array of general governmental powers. As enumerated by the Tax Court:

> It was empowered to reclaim land, make provision for street lighting, sewage, storm drainage, garbage and water service, and parks and playgrounds. It was also empowered to construct small craft harbors, provide fire and police protection, condemn land, enter into contracts, and make and enforce such regulations as were necessary and proper to the exercise of its enumerated powers. A violation of such regulation constituted a misdemeanor.

Foster, 80 T.C. at 58.

We agree with the Tax Court that during the years in issue, the Fosters, as the principal landowners and developers, controlled Estero. Indeed, the California Supreme Court has recognized that the Estero Act was designed by the California legislature to place control of the district in the landowner/developer. Cooper v. Leslie

Salt Co., 70 Cal.2d 627, 451 P.2d 406, 408-409, 75 Cal.Rptr. 766, cert. denied, 396 U.S. 821 (1969). The Tax Court stated:

> There is no question that Estero added value to Brewer's Island. However, it never realized that value because it did not own the land or receive the proceeds from its sale. All we are deciding here is whether the value added by Estero is allocable to the Foster partnership because of the legislatively conferred control that the partnership exercised over the district. To answer that question in the affirmative does not require that we ignore Estero's legal identity as a public agency.

Foster, 80 T.C. at 169. Estero was the Partnership's creature, used by it to improve the land and thus increase its value. That is what it was designed to be and do. Because it is a public body, validly created, its own income, if any, belongs to it, and would not be allocable to some other entity.

Commissioner v. Birch Ranch & Oil Co., 192 F.2d 924 (9th Cir. 1951),on

which the Partnership relies, is quite different from our case. There, the taxpayer owned substantially all the land in a California reclamation district, and, along with certain related parties, substantially all of the district's bonds. In order to pay interest on the bonds, the District made assessment calls which the taxpatyer paid and later deducted as taxes. The Commissioner denied the deduction on the ground that the payor and the payee were economically identical. We upheld the deduction, stating:

> Since the district met the requirements of California law, its status as a district entity, not to be confused with the owners of the ranch, or the taxpayer-corporation, cannot be questioned regardless of the fact that the district served but a single ranch, (plus one 240 acre parcel). The western states have long considered that the reclamation, even of a single parcel of land in single ownership, may justify the exercise of sovereign powers.

192 F.2d at 928. The case dealt with the

validity, as a tax deduction by the owner of the property in the district, of an assessment levied by the district against the landowners and actually paid by the owners to the district. Nothing comparable is involved in our case.

The Tax Court stated that its finding that the Partnership controlled Estero did not conflict with the district's status as a "juristic entity," and therefore, Birch Ranch & Oil was inapposite. 80 T.C. at 169. We agree. The primary question here is not whether Estero is an independent entity. The primary question is whether the Commissioner can allocate to the Partnership the income arising from value created by Estero that would have gone to the Partnership but for the transfers to the Alphabets and Foster Enterprises. The Alphabets' and Foster Enterprises' function was to divert what would normally be the income of the Partnership

away from it and to the Alphabets and Foster Enterprises. If the transfers had not been made, the income in question would not have been Estero's; it would have been that of the Partnership. The relationship between the Partnership and its creatures, the Alphabets and Foster Enterprises, was precisely the same, whether the appreciation in value occurred before the transfers or after them. Under section 482, the Commissioner may allocate income earned subsequent to the income evading event or transfer. The fact that some of it is attributable to a time following the transfers makes no difference. Because Estero did not own the land, the gain in value would never accrue to Estero, but would have accrued to the Partnership, the landowner, but for the transfers. By the transfers, the Partnership shifted that income away from itself and to the Alphabets, which had nothing, and to

Foster Enterprises, which had large losses from unrelated ventures. By that device, the Partnership sought to get out from under large tax liabilities and yet retain control of Foster City. Under § 482, the Commissioner could reallocate to the Partnership the income that the Partnership had shifted to the Alphabets and Foster Enterprises. The transfers had no business function; their purpose was tax avoidance. The Tax Court properly upheld the Commissioner's reallocation.

II. The Westway Notes

A. Form Over Substance Doctrine

As of August, 1962, the Partnership had borrowed $3 million from Republic for the development of Foster City. As an inducement for the loan, the Fosters agreed that, in addition to interest, they would pay a bonus equal to the amount borrowed. Republic desired that the bonus be structured as capital gain

rather than ordinary income. The advantage to the Partnership wouldw be a stepped-up basis in the land.

Thus began a complex succession of incorporations, transfers, liquidations, and mergers. See Foster, 80 T.C. at 198-200. At the core of this arrangement was the conveyance and reconveyance of stock in Foster Bayou, a corporation organized by the Fosters and capitalized with 200 acres of land in Foster City. In August, 1962, the Partnership sold its stock in Foster Bayou to Westway Investment Co. for $5,000 cash and a $100,000 non-interest bearing note. Westway was a subsidiary of Howard Corporation, which in turn was owned by trustees for the benefit of Republic's shareholders. In May, 1964, Esteroy, a corporation organized by the Fosters the previous year and capitalized with $10,000, bought the stock from Westway for $5,000 cash plus $3.1 million in

non-interest bearing notes (Westway Notes). Both Foster Bayou and Esteroy were later liquidated so that the Partnership eventually assumed the notes.

The Tax Court, relying on the well-established doctrine of form over substance, see Stewart, 714 F.2d at 987-88, found that the notes represented an obligation by the Partnership to pay interest on the money borrowed from Republic, rather than the cost of reacquiring the Foster Bayou stock. Consequently, the Tax Court disallowed the Fosters the $3 million stepup in the basis of two of the Foster City neighborhoods. On review, the Tax Court's determination that the Westway transaction was lacking in economic substance will not be set aside unless clearly erroneous. Thompson v. Commissioner, 631 F.2d 642, 646 (9th Cir. 1980), cert. denied, 452 U.S. 961 (1981).

Contrary to the Fosters' assertion

that the notes were indicative of the profit-sharing aspect of a partnership, the Tax Court cites overwhelming evidence that the relationship between the Fosters and Republic was always one of debtor-creditor. Foster, 80 T.C. at 202-203. Additionally, Republic's right to share in the profits was strictly limited in amount, The bank bore no risk of loss except with respect to its loan, and it was not entitled to participate in the management of the project.

The Fosters contend that $3.1 million ($15,500/acre) was a realistic price, not because of evidence that that was the value of the land, but because of the property's alleged investment potential. Their argument that the transaction was made at arm's length, however, is belied by the fact that although the Fosters had originally paid approximately $4500 per acre for the land, Foster Bayou, in selling the stock to Westway for

$105,000, sold it for about $500 per acre. The Tax Court noted that Westway was not equipped to develop the land, nor did it improve the land during its ownership. Moreover, the record contained evidence (correspondence between Jack Foster and his attorney) that that particular parcel was chosen only because it could be expediently transferred. Id. at 94-95.

In any event, the result of this complex series of transactions was that when Esteroy purchased the Foster Bayou stock from Westway, it recovered the $5,000 in cash that it originally paid to purchase the stock; its $100,000 non-interest-bearing note, both of which were due on the same date; Westway's gain on the transaction was therefore $3 million, the amount of the bonus that the Fosters had agreed to pay under their agreement with Republic. Furthermore, the $3 million was structured as capital

gain (gain derived from the sale of corporate stock), which was also part of the agreement. Finally, that the Partnership anticipated the "sale" and "repurchase" of the stock by the Fosters for the purpose of disguising the agreed upon bonus as capital gain was evidenced by correspondence between Jack Foster and his attorney. Foster, T.C. at 94.

United States v. Mississippi Chemical Corporation, 405 U.S. 298 (1972), is distinguishable. In that case, cooperative associations under the Agricultural Marketing Act were required to purchase stock in a member bank as a condition for securing a loan. The Court held that the stock was a capital asset having long-term value. Its cost, therefore, was not deductible as an interest expense. Here, although the Fosters were required to pay a sum in addition to the stated interest rate, they received nothing in return other

than the amount borrowed. An additional reason noted by the Court in Mississippi Chemical for disallowing the interest deduction was that Congress had intended to provide loans to farmers at low interest rates; it therefore would have been "odd" for Congress to have provided a hidden interest charge in the legislation. 405 U.S. at 310. No such considerations of legislative intent apply in this case.

We find that the Westway Notes represented "the amount [the debtor] contracted to pay for the use of borrowed money." Old Colony Railroad Company v. Commissioner, 284 U.S. 552, 560 (1932). Thus, the Commissioner was not clearly erroneous in characterizing them as interest.

B. Capitalization of Interest

The Fosters contend that if the Westway Notes represent an obligation to pay additional interest, then under 26

U.S.C. § 266 (1976), such interest may be capitalized at the election of the Partnership and added to the basis of the land. Section 266 provides:

> No deduction shall be allowed for amounts paid or accrued for such taxes and carrying charges as, under the regulations prescribed by the Secretary, are chargeable to capital account with respect to property, if the taxpayer elects, in accordance with such regulations, to treat such taxes or charges as so chargeable.

The Tax Court, relying on the language of §266, legislative history, and the regulations, found that an item not otherwise deductible may not be capitalized under § 266. Foster, 80 T. C. 212-213. The Partnership used the cash, rather than the accrual, method of accounting. Under the cash method, interest may not be deducted until it is paid. 26 U.S.C. § 461 (1976); Treas. Regs. §§ 1.461-1(a)(1), 1.446-1(c)(1)(i) (1984).

We agree with the Tax Court's

analysis and therefore find that the Partnership may not capitalize interest that it did not pay. The Fosters do not dispute that the Partnership paid no portion of the Westway Notes during the year in issue. Thus, the option of capitalizing the Westway Notes was not available.

Crane v. Commissioner, 331 U.S. 1 (1947), does not change this result. Under Crane, a taxpayer may include the amount of a loan in computing the basis in the property against which the loan is taken. The loan, however, is a part of the cost of the property, whereas interest is the cost of the loan. Congress has expressly provided for interest in the form of a deduction. 26 U.S.C. § 163(a)(1976).

C. Charitable Deductions

The Partnership conveyed three parcels of land in Foster City for which it claimed charitable deductions: a

school site, by gift deed, and two church sites for $20,000 per acre. On its tax returns, the Partnership valued the sites at $40,000 per acre, deducting the difference as a charitable contribution.

A business will not be allowed a charitable deduction if the dominant motive behind the transfer was the expectation of economic benefit. Allan v. United States, 541 F.2d 786, 788 (9th Cir. 1976). Contrary to the Fosters' assertion, this standard was employed by the Tax Court. Foster, 80 T.C. at 223. The Tax Court's determination that the Fosters were not entitled to a charitable deduction will not be overturned unless it was clearly erroneous. Allan, 541 F.2d at 788.

The Tax Court found that, as demonstrated by Estero's prospectus and the Partnership's promotional publications, Foster City was designed to be a self-sufficient community with

provision for all services required by the resident population, including schools and churches. The Tax Court determined that the transfer of the three sites was therefore designed to enhance the value of the Partnership's remaining land and to promote its sale. See Stubbs v. United States, 428 F.2d 885, 886-87 (9th Cir. 1970), cert. denied, 400 U.S. 1009 (1971). Additionally, concluded the Tax Court, the transfer of the school site was made to secure the cooperation of the school district and to persuade the district to abandon its threat to cancel school bus service to Foster City.

The Fosters object to the Tax Court's attributing the representations in Estero's prospectuses to the Partnership. Given our holding that the activities of Estero may not be attributed to the Partnership, we agree with the Fosters' contention. The Fosters, however, do not

the same benefits were touted in the Partnership's publications. Thus, even without attributing the Estero prospectuses to the Partnership, the Tax Court's finding, that there was sufficient motivation of economic benefit to disallow the deductions, was not clearly erroneous.

The Fosters argue that if the transfers are disallowed, the cost of the school site should be capitalized as part of the Partnership's basis in only the residential acreage of the neighborhood the future school would serve (Neighborhood One), rather than the Commissioner's capitalization of the cost as part of the Partnership's basis in all of its remaining land in Foster City. The Fosters state that the only benefit to flow from the transfer was the continued bus service, which was of benefit only to Neighborhood One. We, however, do not believe that the Tax

Court was clearly erroneous in finding that, "[t]he transfer was the first step in implementing the partnership's neighborhood school plan. Moreover, it gave credibility to its 'sales pitch' that Foster City was a planned community. Both of the factors enhanced the value and promoted the sale of land in all the neighborhoods and not just in Neighborhood One." Foster, 80 T.C. at 226.

D. Business Deductions

The Tax Court affirmed the Commissioner's determination that a portion of the Fosters' travel and entertainment expenses were personal to the Fosters and therefore not deductible as business expenses. The deficiency notice did not itemize the particular deductions disallowed, but instead gave the total disallowance for each taxpayer. We note initially that the deficiency notice was not defective. Abatti v.

Commissioner, 644 F.2d 1385, 1389-90 (9th Cir. 1981).

The Commissioner;s deficiency determination carries a presumption of correctness. Rockwell v. Commissioner, 512 F.2d 882, 885 (9th Cir. 1975), cert. denied, 423 U.S. 1015 (1975). The Fosters' reliance on Weimerskirch v. Commissioner, 598 F.2d 358 (9th Cir. 1979), and United States v. Janis, as indicating "that the Commissioner must offer some foundational support for the deficiency determination before the presumption of correctness attaches to it." 596 F.2d at 361. In both Weimerskirch and Janis, however, the Commissioner had determined that the taxpayer had unreported income. As a rationale for its decision, the Weimerskirch court observed that absent a showing by the Commissioner, the taxpayer, in a case of unreported income, would have the difficult task of proving

a negative. Id. Such is not the case with a deduction.

"The presumption in favor of the Commissioner is a procedural device which requires the taxpayer to come forward with enough evidence to support a finding contrary to the Commissioner's determination." Rockwell, 512 F.2d at 885. The evidence offered by the Fosters to rebut the presumption was testimony that their record-keeping system was accurate and that the examining revenue agent so scrambled their records that they could not be reassembled to prove the legitimacy of the claimed deductions. The Fosters do not dispute the Commissioner's assertion that they agreed with several of the Commissioner's adjustments, thus undermining their argument that their record-keeping system was fail-safe. In any event, we agree with the Tax Court that the Fosters' self-certification of their record-

keeping system is not a substitute for proof of their deductions. Deductions are a matter of legislative grace with the taxpayer bearing the burden of their substantiation. Rockwell, 512 F.2d at 886. We cannot say that the Tax Court's decision that the Fosters did not carry this burden was clearly erroneous. See Zmuda v. Commissioner, 731 F.2d 1417, 1421 (9th Cir. 1984).

E. Penalty

The Tax Court affirmed the Commissioner's assessment of a penalty against Jack and Gladys Foster for negligent or intentional disregard of income tax rules and regulations. 26 U.S.C. § 6653(a) (1976). We vacate the assessment. This is a case of first impression with no clear authority to guide the decision makers as to the major and complex issues. The positions taken by the Fosters were reasonably debatable. Under all of the circumstances, we do not

believe it can be fairly said that the Fosters acted negligently or intentionally in disregard of the law.

AFFIRMED in part, VACATED in part.

F O O T N O T E S

1. "Transactions between one controlled taxpayer and another will be subject to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes . . . . In determining the true taxable income of a controlled taxpayer, the district director is not restricted . . . to the case of a device designed to reduce or avoid tax by shifting or distorting income . . . ." Treas. Reg. § 1.482-1(c) (1984) (emphasis added). "Section 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied. . . ." Id. at § 1.482-1(d)(5) (1984) (emphasis added).

2. The Fosters move to augment the record with an additional depositon of A.O. Champlin. The deposition is not properly before this court; the motion is therefore denied. Karmun v. Commissioner, 749 F.2d 567, 570 (9th Cir. 1984).

F I L E D
MAY 30 1985
PHILLIP B. WINBERRY
Clerk, U.S. COURT
OF APPEALS

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

RICHARD H. FOSTER and SARA B. FOSTER, T. JACK FOSTER, Jr. and PATRICIA FOSTER, JACK R. FOSTER and CAROLINE FOSTER, and ESTATE OF T. JACK FOSTER, Deceased, GLADYS H. FOSTER, Executrix, and GLADYS H. FOSTER,	No. 83-7745
	TAX NO. 1717-78
Petitioners-Appellants,	
v.	ORDER
COMMISSIONER OF INTERNAL REVENUE,	
Respondent-Appellee.	

Before: DUNIWAY, KENNEDY, and ANDERSON, Circuit Judges.

The panel as constituted in the above case has voted to deny the petition for rehearing and to reject the suggestion for a rehearing en banc.

The full court has been advised of the suggestion for en banc rehearing, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b).

The petition for rehearing is denied and the suggestion for a rehearing en bank is rejected.